Companies I and II filed a consolidated return in 1927. The question presented in the *Woolford* case may be stated as follows: May the 1925 and 1926 net losses of Company I, which were sustained prior to its affiliation with Company II, be deducted from the 1927 income of Company II in computing the 1927 consolidated net income of Companies I and II; it being conceded that the 1927 loss of Company I may be properly so deducted?[8]

The statute which is controlling in both the case at bar and the *Woolford* case is the Revenue Act of 1926. The pertinent provisions of Section 206 (b) of such Act are as follows:

> "If, for any taxable year, it appears * * * that any *taxpayer* has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the *taxpayer* for the succeeding taxable year * * *, and if such net loss is in excess of such net income (computed without such deduction) the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year * * *." [Italics supplied.]

ARGUMENT

(I) THE FUNDAMENTAL PROBLEM INVOLVED.

In view of the provisions of Section 206 (b) of the Revenue Act of 1926, the questions presented in the case

[8]Both the District Court (44 Fed. (2nd) 856) and the Circuit Court of Appeals (53 Fed. (2nd) 825) refused to allow the deduction.

at bar and in the *Woolford* case may be restated as a single, fundamental problem as follows:

When affiliated companies file a consolidated return as authorized by Section 240[9] of the Revenue Act of 1926, who or what is the "taxpayer" as such term is used in Section 206 (b)?

Three possible answers to this fundamental problem have been suggested by the Courts and the Board of Tax Appeals, as follows:

The First Answer

The first answer is that the TAXPAYER is the *underlying economic unit* which over a period of years enjoys the ultimate income or suffers the ultimate loss sustained in the conduct of a business which is carried on through the instrumentality of affiliated corporations.

Under this interpretation of Section 206 (b), the income earned by the underlying economic unit in the operation of its business in one year may be reduced by the total net loss which the same underlying economic unit sustained in the operation of its business in the preceding year. It is the loss or income of the *unit* which is controlling, not the losses or incomes of the various

[9]"Section 240(a). Corporations which are affiliated within the meaning of this section may, for any taxable year, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. * * *

"(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each * * *."

affiliated companies through which the economic unit may have conducted its business.

The primary inquiries in treating the question of net losses, if this first answer to the fundamental problem be adopted, are:

(1) What income has the economic unit earned this year?

(2) What net loss did the same economic unit, no matter through what agencies or corporations it may have operated, sustain last year?

This answer to the fundamental problem is stated by the Circuit Court of Appeals for the Third Circuit in its opinion in *National Slag Company* v. *Commissioner*, (1931) 47 Fed. (2nd) 846.

The Second Answer

The second answer is that the TAXPAYER is the *collection of affiliated companies* listed in a consolidated return.

Under this interpretation of Section 206 (b), the *sum* of the gross incomes earned in one year by the various affiliated companies listed in a consolidated return may be reduced not only by the *sum* of the allowable deductions accruing to such companies in the same year but also by the *sum* of the net losses sustained by the *same* companies in the preceding years, no matter with what interests, if any, such companies were then affiliated.

The primary inquiries in treating the question of net losses, if this second answer be adopted, are:

(1) What is the *sum* of the gross incomes of the individual affiliated companies listed in a consolidated return this year?

(2) What is the total of the *sum* of the allowable deductions of such companies for this year and the *sum* of the net losses of the *same* companies last year, no matter with what interests, if any, they were then affiliated?

Obviously, if this interpretation be adopted, the underlying business or economic unit is ignored and the *agencies* through which such unit operates are treated as being of controlling importance.

This second answer to the fundamental problem was first adopted by the Board of Tax Appeals in *Sweets Company of America* v. *Commissioner* (1928), 12 B. T. A. 1285, at 1292, reversed by C. C. A. 2nd (1930), 40 Fed. (2nd) 436.

The Third Answer

The third answer is that each *individual company* is a TAXPAYER, despite the fact that it is a member of an affiliated group of companies through which an *underlying economic unit* operates a business.

Under this interpretation of Section 206 (b), as applied by the respondents, the District Courts and Circuit Courts of Appeals in the case at bar and in the *Woolford* case[10], the deduction allowed thereby is limited to

[10]See also *Commissioner* v. *Ginsburg Co.* (1931), 54 Fed. (2nd) 238, at 240: "Even though both corporations were affiliated in 1927, they each remained taxpayers and their affiliation merely made them a tax computing unit. * * * Since each corporation of the affiliated group is a taxpayer, the net loss of each must be computed separately, and a net loss may not be carried forward and added to a net loss of the taxpayer unless the taxpayer has a net income for a succeeding year."

the deduction of the *individual* net loss sustained by *each* company in an affiliated group in one year from the *individual* income earned by the *same* company in the succeeding year or years, despite the fact that any such company may have been affiliated with one group in the first year and an entirely different group in the succeeding year or years.

The primary inquiries in treating the question of net loss, if this application of the third answer be adopted, are:

(1) What are the respective *individual* incomes of the companies in the affiliated group for this year?

(2) What were the *individual* net losses of such companies, *respectively*, last year, no matter with what interests, if any, they were then affiliated?

This application of the third answer to the fundamental problem was originally propounded in *Swift & Company* v. *U. S.* (1930), 38 Fed. (2nd) 365. Thus, as this third answer has been applied by the respondents and the lower courts in the case at bar and the *Woolford* case, the underlying business or economic unit is completely ignored and the agents (i. e. the members of the affiliated group) through which such unit operates are considered as being of controlling importance. As even a cursory examination of the case of *Swift & Company* v. *U. S.*, *supra*, will show, an attempt to operate under this application of the third answer involves complications of far greater complexity than one would ordinarily expect to find as being the result intended by the

legislative forces enacting so simple a statutory provision as Section 206 of the Revenue Act of 1926.

This same answer, namely, that the taxpayer is the individual corporation has also been adopted by the petitioner in the *Woolford* case and by a long line of opinions in the Board of Tax Appeals,[11] and by an ingenious argument such petitioner and the Board have undertaken to justify a conclusion which would have been the logical and expected result, if they had accepted the definition of the term taxpayer which was proposed by the *Sweets Company of America* case, *supra,* namely that the taxpayer is the collection of affiliated corporations.

Though the petitioner in the *Woolford* case begins its argument in its brief filed in this court with the statement that "each corporation is a separate taxpayer", it nevertheless seeks to have allowed as a deduction from its individual 1927 income the net losses sustained in prior years by a Company which, though affiliated with such petitioner in 1927, was in no way associated with it in the preceding years when such net losses were sustained.

The argument by which such result is sought to be accomplished may be summarized as follows:

> SINCE Section 232 provides that "in the case of *a corporation subject to a tax* * * * the term 'net income' means gross income * * * less the deductions allowed by sections *234 and 206* * * *"; and

[11] *Alabama By-Products Corp.* v. *Commissioner,* 18 B. T. A. 919 (1930—non-acquiescence—now pending before C. C. A. 5th Cir.); *Buckie Printers' Ink Co.* v. *Commissioner* (1930), 19 B. T. A. 943; *Hutt Contracting Co.* v. *Commissioner* (1929), 17 B. T. A. 818; *Struthers-Ziegler Cooperage Co.* v. *Commissioner* (1929), 18 B. T. A. 537; *Warren-Nash Motor Corporation* v. *Commissioner* (1930), 21 B. T. A. 897; *Pittsburgh Gasoline Co.* v. *Commissioner* (1930), 21 B. T. A. 297.

SINCE Section 234 provides that "in computing the net income of *a corporation subject to a tax* * * * there shall be allowed as deductions": the ordinary current expenses and losses of the *corporation* (Sec. 234 (a) (1)) or *taxpayer* (Sec. 234 (a) (2), (4)); and

SINCE Section *206* provides that "if any *taxpayer* has sustained a net loss the amount thereof shall be allowed as a deduction in computing the net income of the *taxpayer* for the succeeding taxable year"; and

SINCE in a consolidated return made pursuant to Section 240 the excess of the deductions allowed by Section 234 to an affiliated corporation over the gross income of that corporation is, under the Regulations and by accepted and unquestioned practice, allowed to offset income of other corporations in the affiliated group; and

If the statement of the respondents in the *Woolford* case and the case at bar to the effect that the *taxpayer* is the *individual corporation* in the affiliated group be correct;

Then the deductions allowed to a corporation (i. e. the taxpayer) under Section *206* must be treated in the same way as deductions under Section 234 and be allowed to offset income of other corporations in the affiliated group.

In considering the soundness of this argument it must be noted that the deductions allowed under Section 234 are only allowed in computing the net income *of the corporation subject to the tax* (Sec. 234 (a) (1)) or the *taxpayer* (Sec. 234 (a) (2), (4)); such terms being used by the act indiscriminately. Hence if, as is the unques-

tioned practice, under this section current expenses of corporation A are allowed as deductions from the current gross income of corporation B, with which it is affiliated, then the resulting net income must be the *net income of the taxpayer,* for it is only in calculating the net income *of the corporation* or the *taxpayer* that such deductions may be taken. Since the net income so computed is, in fact, the net income of the *affiliated group of companies,* that group must, when returns are filed under Section 240, be the *taxpayer.*

The intention of the Sections under discussion thus seems clear. When an individual corporation files an individual return, it is the taxpayer and its prior year net losses and current expenses and losses are allowed to it as deductions from its current gross income. But when a consolidated return is filed pursuant to Section 240, the group of affiliated companies is then the *taxpayer* and all prior year net losses and current expenses and losses of that taxpayer, namely the consolidated net losses and current expenses and losses of the affiliated companies, may be deducted by the *taxpayer* from *its* gross income, namely the consolidated gross incomes of the affiliated companies.

We submit that this conclusion is inevitable and correct, if the affiliated group continues unchanged from year to year. If there be, however, changes in the group resulting from the addition or separation of companies therefrom, then this definition of the term taxpayer, as being the affiliated group, may lead to improper results upon which we shall hereafter comment. It is, therefore, the position of this brief that the taxpayer is the continuing business entity which if such entity over a num-

ber of years operates through the same affiliated group of companies is practically the same as and equivalent to the group itself, and it is, we submit, this fact (namely the practical identity of the affiliated group to the underlying business entity in all cases where over a period of years the business entity has operated through an unchanged group of affiliated companies) which has confused the petitioner in the *Woolford* case and the Board of Tax Appeals. Their argument as summarized on pages 9 and 10 is based upon the treatment given to current losses and expenses sustained during a period when the affiliated group has remained unchanged; hence, their argument for a similar treatment of past year net losses is only sound when applied under similar circumstances, that is to a group of affiliated companies remaining unchanged over a period of years.

(II) THE CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, IN ITS OPINION IN THE NATIONAL SLAG COMPANY CASE, HAS STATED THE ONLY DEFENSIBLE ANSWER TO THE FUNDAMENTAL QUESTION AS TO WHO OR WHAT IS THE "TAXPAYER" WITHIN THE MEANING OF SECTION 206 (b) OF THE REVENUE ACT OF 1926 WHEN THAT SECTION IS APPLIED TO CONSOLIDATED RETURNS FILED PURSUANT TO SECTION 240 OF THAT ACT.

The Court in the *National Slag Company* case, *supra,* defined the TAXPAYER as the fundamental economic unit which over a period of years enjoys the ultimate income or suffers the ultimate losses sustained in the conduct of

a business which is being carried on through the instrumentality of affiliated corporations. The facts in the *National Slag Company* case may be schematically stated as follows:

Tax Yr.	Company I Quakertown & Bethlehem Railroad Company	Company II National Slag Company
1922	NET LOSS	(Not in existence)
1923	NET LOSS	(Not in existence)
1924	LOSS	INCOME

Throughout out each of the years Buckland owned over 96% of the stock of the company or companies in existence in that year.

On January 1, 1924, Buckland organized Company II and a consolidated return for Companies I and II was filed for 1924. The question presented in the *National Slag Company* case may be stated as follows: May the 1922 and 1923 net losses of Company I be deducted from the 1924 income of Company II in computing the 1924 consolidated net income of Companies I and II; it being conceded that the 1924 loss of Company I may be properly so deducted?

In affirmatively answering the question presented in the *National Slag Company* case, that is, in allowing the deductions, the Court, referring to the provisions of Section 206 of the Revenue Act of 1924[12] (which for all

[12] c. 234, 43 Stat. 260.

material purposes are exactly the same as the provisions of the same section of the Revenue Act of 1926), said, at page 847:

> "These sections make it perfectly plain that if the taxpayer in the case at bar had been an individual, he would have had the right to deduct the losses for 1922 and 1923 from his 1924 tax return. * * * The statute does not intimate that its provisions are inapplicable to affiliated corporations. In view of the fact that Buckland owned both companies before and after incorporation of the Slag Company, it seems on principle that the provisions of Section 206 should apply to the consolidated return of these affiliated companies. The return of these companies should be treated as an *economic unit*, and not as separable into various component parts, or individual returns. * * * That one of these instrumentalities forming one of the component parts in the consolidated return was not incorporated until after the losses sought to be deducted were sustained, does not make the provisions on principle inapplicable to the return, for *it was in fact the same instrumentality, but acting in 1924 through corporate forms. * * * The deductions of the losses here in question, sustained in 1922 and 1923, come directly within the provisions of the statute which are plain, certain and unambiguous.*" [Italics and underlining supplied.]

That the Court in the *National Slag Company* case has clearly discerned the true legislative intent expressed in Sections 240 and 206 is abundantly evidenced.

When the Committee on Finance reported to the Senate the first revenue act which authorized the carrying

forward of net losses (Revenue Act of 1918; Section 204[13]) it gave the following explanation of the purposes of the authorization so to do:

> "One of the most important provisions inserted by the Committee is quite new to our tax laws. At the present time no recognition is given to net losses; that is, if in any year, the losses and expenses of a *taxpayer* exceed his gross income, the excess (or in other words the net loss) cannot be carried over into the next year. * * * The chief merit of the present plan is its simplicity of administration. But it does not adequately recognize the exigencies of business and * * * may often result in grave injustice. The Committee has accordingly incorporated an amendment (Sec. 204) which provides that under certain limitations net losses * * * may be deducted in computing the net income of the *taxpayer* for the succeeding taxable year." [Underlining and italics supplied.][14]

With reference to Section 240[15] of the Revenue Act of 1918 which was the first specific statutory authority for the filing of consolidated returns, the Committee on Finance, in reporting to the Senate, said:

> "While the Committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the Committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the *principle of taxing as*

[13]c. 18, 40 Stat. 1061.
[14]Senate Report No. 617, 65th Congress, Third Session, page 7.
[15]c. 18, 40 Stat. 1081.

> *a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government.*" [Underlining and italics supplied.][16]

Pursuant to the provision of Section 240 of the Revenue Act of 1918, the Commissioner of Internal Revenue issued regulations with respect to the filing of consolidated returns thereunder. Article 631 of such regulations (Regulations 45, 1920 edition) provides:

> "The provisions of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the *true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation.*" [Underlining and italics supplied.]

This Court, in *Handy & Harmon* v. *Burnet* (1931), 284 U. S. 136, has adopted the view expressed by the Committee on Finance and in Article 631 of Regulations 45, when it said, at page 140:

> "*The purpose of §240* was, by means of consolidated returns, *to require taxes to be levied according to the true net income and invested capital resulting from and employed in a single business enterprise, even though it was conducted by means of more than one corporation.*" [Underlining and italics supplied.]

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[16]Senate Report No. 617 (*supra*), page 9.

The Federal Courts have consistently followed this Court in this interpretation of Section 240,[17] and the Bureau of Internal Revenue has with equal consistency maintained the position that the income of a group of affiliated corporations is the income of a single business unit.[18]

That the courts have correctly interpreted the legislative intent in construing these sections of the Revenue Act of 1926 and its predecessors is clearly indicated by the report made by the Committee on Finance to the Senate with respect to the Revenue Act of 1928. As that Act was reported by the Committee on Ways and Means to the House,[19] it had abolished consolidated returns after 1929. The Senate Finance Committee reinserted the provisions permitting the filing of consolidated returns, and, in its report to the Senate, explained the purpose of consolidated returns as follows:

> "The permission to file consolidated returns by affiliated corporations *merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. * * * The failure to recognize the entire business enterprise means drawing technical legal distinctions, as con-*

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[17] *Ice Service Company* v. *Commissioner*, 30 Fed. (2nd) 230, at 231 (C. C. A. 2nd); *Flannery & Co.* v. *Commissioner*, 42 Fed. (2nd) 11 (C. C. A. 34d); *Lavenstein Corp.* v. *Commissioner*, 25 Fed. (2nd) 375, at 376 (C. C. A. 4th); *U. S.* v. *Cleveland P. & E. R. R. Co.*, 42 Fed. (2nd) 413 (C. C. A. 6th); *W. S. Bogle & Co.* v. *Commissioner*, 26 Fed. (2nd) 771, at 772 (C. C. A. 7th); *Fidelity National Bank & Trust Co.* v. *Commissioner*, 39 Fed. (2nd) 58, at 61 (C. C. A. 8th); *Golden Cycle Corp* v. *Commissioner*, 51 Fed. (2nd) 927, at 931 (C. C. A. 10th); *Pelican Ice Co.* v. *Commissioner*, 37 Fed. (2nd) 285 (C. C. A. 5th); *Commissioner* v. *Shillito Realty Co.*, 39 Fed. (2nd) 830 (C. C. A. 6th).

[18] O. D. 415, 2 C. B. 226; A. R. R. 448, 4 C. B. 314; A. R. R. 624, 5 C. B. 234; I. T. 1386, I-2 C. B. 32; I. T. 1600, II-1C. B. 184; A. R. R. 2958, II-2 C. B. 214; S. M. 1530, III-1 C. B. 307; L. O. 1113, III-2 C. B. 36; S. M. 2683, IV-1 C. B. 238; S. M. 3384, IV-1 C. B. 277; I. T. 2261, V-1 C. B. 100; I. T. 2355, VI-1 C. B. 98; G. C. M. 6640, VIII-2 C. B. 212.

[19] House Report No. 2, 70th Congress, First Session, page 20.

> *trasted with the recognition of actual facts.* The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. *It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes."* [Italics supplied.][20]

The concluding analogy suggested by the Committee on Finance in the foregoing quotation serves as an excellent means of differentiating between the first and third suggested answers to the fundamental problem involved in the case at bar. Let us take as an example individual X operating a butcher shop and a grocery store in 1924 and 1925. In 1924 X earns a net income in the grocery business and sustains a net loss in his operation of the butcher shop; in 1925 he again has a profit in the grocery business but suffers a further loss in his operation of the butcher shop. It is clear that under Section 206 (b) he as a taxpayer who has suffered a net loss in 1924 in his butcher business may, if such net loss is in excess of the income earned in that year in the grocery business, deduct the excess of such 1924 butcher shop net loss from the net income of the

[20]Senate Report No. 960, 70th Congress, First Session, page 14.

grocery business in 1925 even though the butcher business lost money in both years. Now if it be that individual Y in 1924 were conducting a garage, in the operation of which in that year he sustained a net loss, and if on January 1, 1925, individual X purchased the garage from Y and in the operation of the garage in 1925 also sustained a loss, it is equally clear that X would not be entitled to deduct from such 1925 grocery business income the 1924 garage net loss which had been recorded on the books of the garage business during the year in which it was owned by Y. The reason for this is obvious. The net loss provisions provide that the *taxpayer*, that is, the continuing business entity which from one year to another operates a business enterprise, shall be entitled to deduct losses which *it* has sustained in prior years from income which *it* may earn in certain succeeding years.[21] The law does not provide nor contemplate that *one* taxpayer may deduct from its earned income a loss which has been suffered by *another* taxpayer in a preceding year. Failure fully to appreciate this fact, it is submitted, is the foundation of the fallacy upon which the argument for the petitioner in the *Woolford* case is based.[22]

Neither the second nor the third answer which has been suggested to the fundamental question involved makes any approximation of approaching the legislative intent behind Sections 240 and 206. To hold that the taxpayer is the "collection of affiliated companies" as it may exist in any given year regardless of the affiliation

[21]The net loss provision grants a right which is personal to the *Taxpayer*. *Bush* v. *Commissioner*, 50 Fed. (2nd) 800 (C. C. A. 5th), (1931).
[22]See discussion at page 9.

of such companies in prior years, or that the taxpayer is the "individual affiliated company" clearly ignores the "single business enterprise" of which this Honorable Court has spoken in *Handy & Harmon* v. *Burnet, supra.* In fact to adopt either of such views would mean not only the failure to recognize what courts and legislators alike have recognized as the intent behind Sections 240 and 206 (b) but the authorization of applications of such sections which would permit illogical and unjustifiable tax evasions.

If net losses are to follow individual companies as stock control of such companies is transferred from one business or economic unit to another, which is the inevitable result of defining the term "taxpayer" as meaning either each *"individual company"* in an affiliated group or the *"collection of affiliated companies"* in such group, then "net losses" take their place in the market as proper subjects of barter and sale. The successful corporation earning a large income could purchase the stock of a highly *un*successful corporation which over a period of years had sustained heavy unabsorbed losses and would be authorized thus by such losses to offset its own taxable income. It is obvious that the stock of the highly unsuccessful corporation could be purchased at a very nominal figure, but the resulting benefit to the purchasing corporation would, if the losses of the unsuccessful corporation were sufficiently large, be substantial. We submit that the Congress could not have intended that Section 206 be so interpreted as to permit any such outright tax evasion. A definition of the term "taxpayer" which makes of Section 206 a means by which the remaining sections

of the Revenue Act may be flouted must of necessity be false.[23]

(III) THE "TAXPAYER", WHEN SUCH TERM IS APPLIED TO THE PROVISIONS OF THE REVENUE ACT OF 1926 WHICH INVOLVE CONSOLIDATED RETURNS, MEANS THE UNDERLYING ECONOMIC UNIT WHICH IN THE CASE OF A CLASS A AFFILIATION[24] IS THE "PARENT CORPORATION" WHICH "OWNS AT LEAST 95 PER CENTUM OF THE VOTING STOCK OF THE OTHER OR OTHERS", AND IN THE CASE OF A CLASS B AFFILIATION IS THE STOCK OWNING INTEREST (OR INTERESTS) WHICH IS TAXED THROUGH THE "PRINCIPAL REPORTING CORPORATION", AS SUCH TERM IS USED IN ARTICLE 632 OF REGULATIONS 69.[25]

We have shown above (pages 9 to 11) that the provisions of the Revenue Act themselves preclude a decision that, in considering the application of Section 206 (b), the taxpayer is the individual company. It must be the underlying economic unit which, where no change has taken place from year to year in the consolidated group, is, of course, the consolidated group.

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[23]Article 41(c) of Regulations 75 may not be cited to defeat this conclusion since it did not become effective until January 1, 1929. For more than 10 years prior to that date the net loss provisions have been in force and the definition of the term "taxpayer" adopted by this court in the decision of the case at bar will, without benefit of Article 41(c) of Regulations 75, carry out or defeat the clear intent behind the provisions of Section 206 of the Revenue Act of 1926 and the corresponding Sections of the several Revenue Acts beginning with that of 1918.

[24]Section 240(c) of the Revenue Act of 1926: "For the purpose of this Section two or more domestic corporations shall be deemed affiliated (1) [a Class A affiliation] if one corporation owns at least 95 per centum of the voting stock of the other or others, or (2) [a Class B affiliation] if at least ninety-five per centum of the voting stock of two or more corporations is owned by the same interests."

[25]Art. 632, Reg. 69; "The consolidated return shall be filed * * * by the parent or principal reporting corporation in the office of the collector of the district in which it has its principal office."

The provisions of the statute speak for themselves.

> "The term *'taxpayer'* means any *person* subject to a tax imposed by this Act". (Sec. 2 (a) (9); Rev. Act of 1926).
>
> "The term *'person'* means an individual, a trust or estate, a partnership or a *corporation*." (Sec. 2 (a) (1); Rev. Act of 1926).
>
> "Corporations which are affiliated * * * may * * * make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return." (Sec. 240 (a); Rev. Act of 1926).
>
> "In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon between them, * * *. There shall be allowed in computing the income tax only one specific credit computed as provided in Subdivision (b) of Section 236." [which section allowed a $2,000 tax credit to domestic corporations] (Sec. 240 (b); Rev. Act of 1926).
>
> "The consolidated return shall be filed * * * by the *parent* or principal reporting corporation * * *." (Art. 632. Reg. 69).

Thus a consolidated return is treated for all purposes except assessment, as that of one corporate taxpayer, which corporate taxpayer is allowed one corporate credit, and has the financial characteristics, current capitalization and earnings, and past financial history, of the business entity which operates through the affiliated corporations named in the return as filed.

Thus—to paraphrase, and it is submitted, correct the statement made by the Court of Claims in its opinion in the *Swift* case[20] (*supra*)—the *consolidated group*, as such, is not the taxpayer, but is a *tax computing unit: the individual corporations*, which are members of the affiliated group, are not the taxpayers, but are the tax transmitting units, that is, the means by which the taxpayer, the underlying business entity, transmits the tax payable upon its net income to the tax collecting authorities; and the *underlying business entity* is the taxpayer referred to in Section 206 (b).

We submit that it is clear that in the case of a Class A affiliation the underlying economic unit is the parent corporation; that subsidiaries as they are created or acquired must be regarded as becoming a part of that economic unit; that as subsidiaries are dissolved or disposed of they cease to be part of the economic unit; and that where subsidiaries are sold, each assumes or receives a separate economic and taxable status. To use a simply analogy—the parent company is the fruit tree, which remains the fruit tree even though it gain branches by grafting and lose branches by pruning. When a corporation is grafted on a pre-existing group, such corporation does not bring with it losses which it theretofore sustained, because such losses were not losses of the existing group or economic unit.

That such is the correct theory is indicated by T. D. 4022, dated June 14, 1927.

So also it is clear from the provisions of the statute

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[20] *Swift & Co.* v. *U. S.*, 38 Fed. (2nd) 365, at 375; "The consolidated group, as such, is not a taxpayer but a tax computing unit, and the corporations which are members of the affiliated group for the year * * *" are the taxpayers.

itself that in a class B affiliation the economic unit is the stock owning interest (Chapman in the case at bar) or interests which are taxed through the "principal reporting corporation." Thus corporate activity is taxed upon a corporate basis, with corporate deductions allowed and corporate net income definitions applicable, while, at the same time the actual fact of the existence of one underlying business enterprise is not obscured by the fact of the existence of a means by which that enterprise operates, namely, an affiliated group of corporations.

It is further respectfully submitted that the position taken in this brief does not do violence to the corporate entities of the affiliated corporations as was the belief of the Circuit Court of Appeals for the Fifth Circuit which in its opinion in the case at bar said:

> "It is true that the facts of this case * * * do present a situation of which if the matter were to be determined upon considerations of general fitness, it might be well said, * * * 'It seems on principle that the provisions of Sec. 206 should apply to the consolidated return of these affiliated companies'; but the question may not be decided upon such considerations. * * * It is the general rule that the corporation and the stockholders are essentially distinct entities, and though to circumvent fraud the corporate entity may be regarded as a fiction, ordinarily it must be regarded as having a real, a substantial existence. * * * The whole structure of the Federal taxing system is based upon a recognition of and exact compliance with these distinctions. Fraudulent pretense absent, the Government accept the taxpayer as it represents itself to be and one may not, chameleonlike,

change that appearance to suit his necessity or his convenience."[27]

No chameleonlike tactics are or have been attempted by the petitioner in the case at bar. It is not seeking to change its appearance to suit its convenience but merely to secure a proper application of the provisions of the Revenue Acts of the United States which provide, in the language of the Regulations issued by the Commissioner (as authorized by the Acts themselves[28] for the purpose of carrying into effect the intent of Sections 240 and 206), that the intent thereof is to tax "the true net income and invested capital resulting from and employed in *a single business enterprise* even though the business is operated through more than one corporation."[29] That the Federal Government *can* tax such a single business enterprise and *can* for that purpose avail itself of the affiliated group of corporations, through which such enterprise has elected to do business, as a tax computing unit and avail itself of such corporations themselves as tax transmitting units is axiomatic.[30] It would seem, therefore, that the fears of the Circuit Court for the Fifth Circuit for the security of the corporate entity were unfounded. That entity is to continue and to serve the Federal authorities in an effort to levy a just tax upon a single business enterprise in accordance with the clear legislative

[27] *Planters' Cotton Oil Company* v. *Hopkins*, 53 Fed. (2nd) 825, at 826.

[28] Sec. 1101, Revenue Acts of 1926 and 1924; Sec. 1303, Revenue Act of 1921; and Sec. 1309, Revenue Act of 1918.

[29] Article 631, Regulations 45 (1920 ed.).

[30] The power of Congress to tax extends to taxes of every kind and nature and, except as limited by the Constitution, "reaches every subject and may be exercised at discretion". *License Tax Cases*, 5 Wall. (U. S. (462 L. ed. 497) 1866).

intent as expressed in Sections 240 and 206 of the Revenue Act of 1926.[31]

CONCLUSION

It is submitted, therefore, that the opinion in *National Slag Company* v. *Commissioner*, 47 Fed. (2nd) 846, is right; that the decisions in the lower courts in the case at bar are wrong; and that the judgment of the Circuit Court of Appeals for the Fifth Circuit in the case at bar should be reversed.

Respectfully submitted,

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[31] In this brief scant attention has been given to the opinions of the Board of Tax Appeals since on the question at issue its opinions have been too vacillating to be helpful. In *Sweets Company of America* v. *Commissioner* (1928) 12 B. T. A. 1285, reversed in 40 Fed. 2nd 436 (C. C. A. 2nd Cir., 1930), the Board held the "taxpayer" to be "the affiliated group, as such", that is *"the collection of affiliated companies"*, as such term has been used in the foregoing discussion; in the *first Alabama By-Products decision* (1929—16 B. T. A. 1073) the Board held the "taxpayer" to be "each individual affiliated corporation"; in the *second Alabama By-Products decision* (1930—18 B. T. A. 919), based, it is submitted, on an improper application of *Moore Cotton Mills Company* v. *Commissioner* (1929) 17 B. T. A. 662, affirmed in 49 Fed. (2nd) 59 (C. C. A. 4th Cir., 1931), the Board continued to *say* that the "taxpayer" was the individual stockholder, but by means of an argument which is essentially the same as that summarized on page 9 of this brief, permitted deductions of net losses which can only be explained on the theory that the "taxpayer" is the "collection of affiliated companies"; in a great number of cases which followed the *second Alabama By-Products decision* the position there taken was followed unquestioningly (see opinions cited in foot note 11 on page 9); and finally in *Bowman Hotel Corporation* v. *Commissioner* (1931), 24 B. T. A. 1193, 1209-1210, the Board abandoned the *second Alabama By-Products decision* and reverted to the position taken by it in the *first Alabama By-Products decision* in which it said that the "taxpayer" was "the individual corporation" and *followed that statement* to its logical but indefensible conclusions.